

DIRECT TESTIMONY OF

ZACHARY J. PAYNE

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2018-319-E

**IN RE: APPLICATION OF DUKE ENERGY CAROLINAS, LLC FOR
ADJUSTMENTS IN ELECTRIC RATE SCHEDULES AND TARIFFS AND
REQUEST FOR AN ACCOUNTING ORDER**

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND OCCUPATION.

A. My name is Zachary J. Payne. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the South Carolina Office of Regulatory Staff (“ORS”) in the Audit Department as a Senior Auditor.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS EXPERIENCE.

A. I received a Bachelor of Science Degree in Business Administration with a double major in Accounting and Economics from the University of South Carolina in May 2013. I began employment with ORS in March 2015 and since have worked on cases dealing with the regulation of nuclear waste, natural gas, water and wastewater companies.

Q. WHAT IS THE MISSION OF THE OFFICE OF REGULATORY STAFF?

A. ORS represents the public interest as defined by the South Carolina General Assembly as:

The concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of

1 continued investment in and maintenance of utility facilities so as to provide
2 reliable and high-quality utility services.

3 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS**
4 **PROCEEDING?**

5 **A.** The purpose of my testimony is to set forth ORS's findings and recommendations
6 for certain adjustments resulting from ORS's examination of the application of Duke Energy
7 Carolinas, LLC ("Company" or "DEC"), in Docket No. 2018-319-E. Specifically I will be
8 addressing ORS's findings and recommendations for Company Adjustments 7, 13, 18, 19,
9 30, and 35, all of which are related to accounting deferrals. These findings and
10 recommendations are explained in detail in my testimony.

11 **Q. PLEASE OUTLINE THE FUNCTION OF AN ACCOUNTING ORDER TO DEFER**
12 **COSTS.**

13 **A.** An accounting order to defer costs is a regulatory instrument in which the regulatory
14 commission issues an order at the utility's request to establish a regulatory asset (or liability)
15 account into which certain costs can be deferred. The Governmental Accounting Standards
16 Board's (GASB) statement No. 62 provides, among other things, general standards of
17 accounting for the effects of regulation and states that:

18 A regulated business-type activity should capitalize all or part of an incurred
19 cost that otherwise would be charged to expense if both of the following
20 criteria are met:

- 21 a. It is probable that future revenue in an amount at least equal to the
22 capitalized cost will result from inclusion of that cost in allowable
23 costs for rate-making purposes.
24 b. Based on available evidence, the future revenue will be provided
25 to permit recovery of the previously incurred cost rather than to
26 provide for expected levels of similar future costs.

27 In other words, GASB identifies the key criteria the utility must meet to capitalize costs
28 through an approved regulatory asset:

- 1) the incurred costs are likely to be recoverable for ratemaking purposes; and,
- 2) the costs have already been incurred, and the costs are not similar to costs the utility may incur in the future.

GASB statement No. 62 also indicates the utility should accrue “carrying charges” on the regulatory asset:

During the period between the date on which the new asset is recognized and the date on which recovery begins, the carrying amount should be increased by accruing a carrying charge.

GASB outlines the accounting standards for deferring costs; however, it is ultimately the regulatory commission that determines what costs in the regulatory asset are allowable for ratemaking purposes, and the manner in which the utility is allowed to recover the allowable costs in the regulatory asset.

Once an accounting order is issued by the regulatory commission, the utility will create a regulatory asset account on the balance sheet and record costs to the regulatory asset as the costs are incurred. The utility will request to recover regulatory assets in a future general rate case proceeding. It is during the general rate case proceeding the regulatory commission will determine the appropriate amount of allowable costs to be recovered from customers, and the manner in which the utility is allowed to recover allowable costs. Accounting orders to defer costs are used by a utility to smooth earnings and rate recovery related to significant costs that arise from circumstances that are unexpected and/or non-recurring.

Q. WILL ORS REQUEST THE COMMISSION CONSIDER GUIDELINES FOR FUTURE DEFERRAL REQUESTS?

1 **A.** Yes. In Docket No. 2018-206-E, DEC, Duke Energy Progress, LLC (collectively “the
2 Companies”) and ORS discussed the Companies’ request for approval of an accounting order
3 to defer certain capital and operating expenses pursuant to S.C. Code Ann. § 58-27-1540 and
4 S.C. Code Regs. 103-825 (Supp. 2015) related to the Power/Forward Initiative. On
5 September 4, 2018, ORS filed a letter in the docket to inform the Commission that ORS
6 would make a future filing in 2019 to request a proceeding to adopt guidelines on future
7 deferral requests. ORS intends to make such a filing no later than December 2019.¹

8 **Q. PLEASE SUMMARIZE ORS’S RECOMMENDATIONS FOR THE TREATMENT**
9 **OF ACCOUNTING DEFERRALS PROPOSED BY THE COMPANY.**

10 **A.** ORS reviewed each of the Company’s proposals for recovery of accounting deferrals
11 and has developed a recommendation to be applied to the request by the Company to recover
12 its deferred costs. In each of the Company’s proposed deferrals the Company calculated a
13 weighted average cost of capital (“WACC”) return on deferred costs. Additionally the
14 Company proposed to include the unamortized balance of each deferral in rate base. ORS
15 recommends each deferral balance be separated into two categories of costs, operating-
16 related costs and capital related costs. ORS recommends the recovery of both the operating-
17 related costs and the capital-related costs be subject to the same regulatory accounting
18 treatment required for each category absent an accounting deferral. According to the National
19 Association of Regulatory Utility Commissioners (“NARUC”) Rate Case and Audit Manual,
20 regulatory assets and other deferrals should be examined to determine if the deferred costs
21 are appropriate to be included in rate base. The Company may recover prudently incurred
22 operating expenses, without a WACC return or rate base treatment. The Company may

¹ <https://dms.psc.sc.gov/Attachments/Matter/36a3a7be-111b-4103-8131-bd54da3ec5de>

1 recover prudently incurred capital costs by recording capital costs to rate base and recovering
2 those costs through depreciation expense over the life of the associated asset, while earning
3 a WACC return on the undepreciated balance. With the exception of deferred environmental
4 costs in Adjustment #18, the ORS recommendations allow the Company to fully recover its
5 deferred expenses. ORS's recommendations focus on how those costs should be recovered.
6 ORS's recommendations are in the public interest because the recommendations allow for a
7 return of costs and, where it is appropriate a return on costs.

8 **Q. PLEASE EXPLAIN ORS'S RECOMMENDED ADJUSTMENTS.**

9 **A.** Explanations of the accounting and pro forma adjustments are presented on a South
10 Carolina retail basis for both ORS and the Company. As shown on Audit Exhibit GS-2, the
11 ORS adjustment numbers are the same as those filed by the Company in its Application. My
12 recommended adjustments for accounting deferrals are as follows:

13 Adjustment #7 – Amortize Deferred Cost Balance Related to Carolinas West Control Center

14 The Company proposes to adjust depreciation and amortization expense by
15 \$1,781,000, income taxes by (\$444,000), working capital investment by \$3,563,000, and
16 accumulated deferred taxes by (\$889,000) to amortize the deferred cost balance related to
17 Carolinas West Control Center (CWCC). ORS proposes to adjust depreciation and
18 amortization expense by \$168,000, income taxes by (\$42,000), working capital investment
19 by \$3,501,000, and accumulated deferred taxes by (\$874,000) to amortize the deferred cost
20 balance related to CWCC.

21 Commission Order No. 2018-552 granted the Company's request "to defer in a
22 regulatory asset account the return and depreciation on the capital costs associated with the
23 Company's Carolinas West Primary Distribution Control Center incurred since January 1,

2018.” The Commission order also stated “Such relief will not prejudice the right of any party to address the prudence of such costs in a subsequent rate case proceeding.” The Company provided ORS with support for a deferral balance of \$5,344,000 consisting of \$3,622,000 in deferred cost of capital, \$1,420,000 in deferred depreciation expense, and \$301,000 in after-tax return on deferred costs. The Company proposes amortizing this deferral balance over a three year period, and including the balance less one year of amortization in rate base.

ORS proposes a deferral balance of \$5,042,000 which will provide the Company a recovery of the same deferred cost of capital and deferred depreciation expense as the Company’s proposal, but does not include a return on those deferred costs. ORS recommends the deferred cost of capital portion of the deferral balance be included in rate base. ORS does not recommend that the deferred depreciation expense portion of the deferral balance be included in rate base. ORS’s recommendation to include the deferred cost of capital portion of the deferral in rate base, and exclude the deferred depreciation expense from rate base is consistent with regulatory accounting practices for capital-related and operating-related costs. ORS’s recommendation still allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include depreciation expense in rate base, the Company will earn a return on its depreciation expense.

ORS proposes amortizing the deferral balance over a period of 30 years. This amortization period was provided by the ORS Utility Rates Department, and is addressed in more detail in the testimony of ORS witness Willie Morgan.

Adjustment #13 – Amortize Deferred Cost Balance Related to Lee Combined Cycle

1 The Company proposes to adjust depreciation and amortization expense by
2 \$7,154,000, income taxes by (\$1,785,000), working capital investment by \$14,309,000, and
3 accumulated deferred taxes by (\$3,570,000) to amortize the deferred cost balance related to
4 Lee Combined Cycle (LCC). ORS proposes to adjust depreciation and amortization expense
5 by \$563,000, income taxes by (\$140,000), working capital investment by \$14,473,000, and
6 accumulated deferred taxes by (\$3,611,000) to amortize the deferred cost balance related to
7 LCC.

8 Commission Order No. 2018-552 granted the Company's request "to defer the return
9 and depreciation expense, property taxes, incremental non-fuel operating and maintenance
10 expenses and carrying costs at the weighted average cost of capital in connection with the
11 addition of the W.S. Lee combined cycle plant incurred since January 1, 2018." The
12 Commission order also stated that "(s)uch relief will not prejudice the right of any party to
13 address the prudence of such costs in a subsequent rate case proceeding." The Company
14 provided ORS with support for a deferral balance of \$21,463,000 consisting of \$14,184,000
15 in deferred cost of capital, \$4,581,000 in deferred depreciation expense, \$843,000 in deferred
16 operation and maintenance ("O&M") expense, \$940,000 in deferred property tax expense,
17 and \$915,000 in pre-tax return on deferred costs. The Company proposes amortizing this
18 deferral balance over a three year period, and including the balance less one year of
19 amortization in rate base.

20 ORS proposes a deferral balance of \$21,946,000 which will provide the Company a
21 recovery of the same deferred cost of capital, deferred depreciation, deferred O&M, and
22 deferred property tax expenses as the Company's proposal, but does not include a return on
23 those deferred costs. ORS recommends the deferred cost of capital portion of the deferral

1 balance be included in rate base. ORS does not recommend that the deferred depreciation,
2 O&M, and property tax expense portion of the deferral balance be included in rate base.
3 ORS's recommendation to include the deferred cost of capital portion of the deferral in rate
4 base, and exclude the deferred depreciation, O&M, and property tax expenses from rate base
5 is consistent with regulatory accounting practices for capital-related and operating-related
6 costs. ORS's recommendation still allows the Company to recover its actual deferred costs
7 through amortization of the proposed deferral balance which is a sufficient level of cost
8 recovery. If the Company is allowed to include depreciation, O&M and property tax expense
9 in rate base, the Company will earn a return on these expenses.

10 ORS proposes amortizing the deferral balance over a period of 39 years. This
11 amortization period was provided by the ORS Utility Rates Department, and is addressed in
12 more detail in the testimony of ORS witness Willie Morgan.

13 Adjustment #18 – Amortize Deferred Environmental Costs

14 The Company proposes to adjust depreciation and amortization expense by
15 \$48,381,000, income taxes by (\$12,071,000), working capital investment by \$193,522,000,
16 and accumulated deferred taxes by (\$48,284,000) to amortize the deferred environmental
17 costs. ORS proposes to adjust depreciation and amortization expense by \$19,226,000,
18 income taxes by (\$4,797,000), working capital investment by \$75,232,000, and accumulated
19 deferred taxes by (\$18,770,000) to amortize the deferred environmental costs.

20 Commission Order No. 2016-490 granted the Company's request "for an accounting
21 order authorizing the deferment of certain costs incurred in connection with complying with
22 federal and state environmental remediation requirements related to permanently closing
23 coal ash basins and other ash storage units at the Companies' coal fired generating facilities."

1 The Commission order also stated “This ruling in no way limits the ability to challenge the
2 reasonableness of these expenditures in a subsequent general rate case or other proceeding.”
3 The Company provided ORS with support for a deferral balance of \$241,903,000 consisting
4 of \$217,207,000 in deferred asset retirement obligation (“ARO”) plant spend, (\$22,061,000)
5 in nuclear decommissioning trust fund (“NDTF”) overcollection offset, \$35,696,000 in after-
6 tax WACC return on the ARO plant balance, \$8,101,000 for a WACC return on the non-
7 ARO plant balance, \$2,678,000 for deferred depreciation of the non-ARO plant balance, and
8 \$281,000 for an after-tax return on the deferred non-ARO costs. The Company proposes
9 amortizing this deferral balance over a five year period, and including the balance less one
10 year of amortization in rate base.

11 ORS proposes a deferral balance of \$96,131,000 which includes \$95,334,000 in
12 deferred ARO plant spend, (\$22,061,000) in NDTF overcollection offset, \$14,389,000 in
13 after-tax WACC return on the ARO plant balance, \$6,377,000 for a WACC return on the
14 non-ARO plant balance, and \$2,091,000 for deferred depreciation of the non-ARO plant
15 balance. ORS proposes including in rate base all components of the deferral balance (less
16 one year of amortization) except for the deferred depreciation of the non-ARO plant balance.
17 ORS’s recommendation to include the deferred capital costs portion of the deferral in rate
18 base, and exclude the deferred depreciation expense from rate base is consistent with
19 regulatory accounting practices for capital-related and operating-related costs.

20 ORS calculated its proposed deferral balance starting with the allowable ARO system
21 expenditure through August 31, 2018 provided in the testimony of ORS witness Dan Wittliff.
22 ORS Audit Department calculated an allowable percentage per month based on Mr. Wittliff’s
23 recommended total amount and applied that percentage to the ARO monthly expenditures

1 that were originally provided by the Company. Creating an allowable monthly expense
2 allocation was necessary to calculate the WACC return in a manner consistent with the
3 Company's original calculation. ORS then added the non-ARO WACC return and deferred
4 depreciation expense to the allowable ARO plant spend, less NDTF overcollection, plus
5 WACC return on the allowable plant balance. ORS does not recommend the Commission
6 adopt the Company's calculation of a WACC return on the non-ARO deferred cost of capital
7 and deferred depreciation expense. ORS did not include such a return in the proposed deferral
8 balance. If the Company is allowed to include depreciation expense in rate base, the
9 Company will earn a return on these expenses.

10 Adjustment #19 – Amortize Deferred Cost Balance Related to South Carolina Advanced
11 Metering Infrastructure (“SC AMI”)

12 The Company proposes to adjust depreciation and amortization expense by
13 \$12,626,000, income taxes by (\$3,150,000), working capital investment by \$25,252,000, and
14 accumulated deferred taxes by (\$6,300,000) to amortize the deferred cost balance related to
15 SC AMI. ORS proposes to adjust depreciation and amortization expense by \$2,175,000,
16 income taxes by (\$543,000), working capital investment by \$19,210,000, and accumulated
17 deferred taxes by (\$4,793,000) to amortize the deferred cost balance related to SC AMI.

18 Commission Order No. 2016-489 granted the Company's request “to defer into a
19 regulatory asset until the Company's next general rate case: 1) the financial effects of the
20 depreciation expense of the AMI meter deployment described above, the carrying costs on
21 the investment at its weighted average cost of capital, and the carrying costs on the deferred
22 costs at its weighted average cost of capital not to exceed \$45 million;” The Commission
23 order also stated that “(a)n accounting order granting the relief that the Company seeks will

1 not preclude the Commission or parties from addressing the reasonableness of the costs
2 deferred for AMI meters in the Company's next general rate proceeding." The Company
3 provided ORS with support for a deferral balance of \$37,878,000 consisting of \$22,484,000
4 in deferred cost of capital, \$11,936,000 in deferred depreciation expense, and \$3,458,000 in
5 after-tax return on deferred costs. The Company proposes amortizing this deferral balance
6 over a three year period, and including the balance less one year of amortization in rate base.

7 ORS proposes a deferral balance of \$32,629,000 which will provide the Company a
8 recovery of the same deferred cost of capital and deferred depreciation expense as the
9 Company's proposal, but does not include a return on those deferred costs. ORS recommends
10 the deferred cost of capital portion of the deferral balance be included in rate base. ORS does
11 not recommend that the deferred depreciation expense portion of the deferral balance be
12 included in rate base. ORS's recommendation to include the deferred cost of capital portion
13 of the deferral in rate base, and exclude the deferred depreciation expense from rate base is
14 consistent with regulatory accounting practices for capital-related and operating-related
15 costs. ORS's recommendation still allows the Company to recover its actual deferred costs
16 through amortization of the proposed deferral balance which is a sufficient level of cost
17 recovery. If the Company is allowed to include depreciation expense in rate base, the
18 Company will earn a return on its depreciation expense.

19 ORS proposes amortizing the deferral balance over a period of 15 years. This
20 amortization period was provided by the ORS Utility Rates Department, and is addressed in
21 more detail in the testimony of ORS witness Willie Morgan.

22 Adjustment #30 – Adjust for Customer Connect Additional Expense and Deferral

1 The Company proposes to adjust other O&M by \$4,025,000, depreciation and
2 amortization expense by \$1,796,000, income taxes by (\$1,452,000), working capital
3 investment by \$3,592,000, and accumulated deferred taxes by (\$896,000) to adjust for
4 Customer Connect additional expenses and to amortize deferred costs. ORS proposes to
5 adjust depreciation and amortization expense by \$1,063,000, and income taxes by (\$265,000)
6 to adjust for the amortization of deferred costs related to Customer Connect.

7 Commission Order No. 2018-552 granted the Company's request "to defer in a
8 regulatory asset account the incremental operating and maintenance expenses associated
9 with the deployment of the Company's new billing and Customer Information System,
10 known as Customer Connect, and carrying costs on the deferred costs at its weighted average
11 cost of capital incurred since January 1, 2018." The Commission order also stated "The
12 deferred costs to be recorded on the Company's accounting records will be based on actual
13 costs" and that "Such relief will not prejudice the right of any party to address the prudence
14 of such costs in a subsequent rate case proceeding." The Company provided ORS with
15 support for a deferral balance of \$5,388,000 consisting of \$2,507,000 in actual deferred
16 O&M expenditures as of September 30, 2018, \$2,621,000 in estimated deferred O&M
17 expenditures between October 1, 2018 and May 31, 2019, and a calculated weighted average
18 cost of capital return of \$260,000. The Company proposes amortizing this deferral balance
19 over a three year period, and including the balance less one year of amortization in rate base.

20 Additionally, the Company proposes adjusting other O&M expense by \$4,025,000.
21 This adjustment represents the difference between the Company's actual test year O&M
22 expense attributable to the Customer Connect project of \$640,000, and the Company's
23 projected average annual O&M expense of \$4,665,000 during the 2019 and 2020 years.

1 ORS proposes a deferral balance of \$3,189,000 which consists of the Company's
2 actual deferred O&M expenditures as of December 31, 2018. As ordered by the Commission,
3 ORS does not recommend including the Company's estimated O&M expenditures in the
4 deferral balance as they are not actual costs. ORS does not recommend a return on any
5 deferred expenses, and ORS does not recommend that any of the deferral balance be included
6 in rate base since the balance consists entirely of deferred O&M expense. ORS's
7 recommendation to exclude the actual deferred O&M expense from rate base is consistent
8 with regulatory accounting practices for operating-related costs. ORS's recommendation still
9 allows the Company to recover its actual deferred costs through amortization of the proposed
10 deferral balance which is a sufficient level of cost recovery. If the Company is allowed to
11 include deferred O&M expenses in rate base, the Company will earn a return on its O&M
12 expenses.

13 The Company proposes to increase other O&M expense by \$4,025,000 which the
14 Company identified as an estimate. The Company should not be allowed to recover estimated
15 or projected O&M expenditures as they are not known and measurable. The Company
16 recorded \$640,000 in actual O&M expense during the test year attributed to the Customer
17 Connect project and ORS recommends approval of these known and measurable expenses.

18 Adjustment #35 – Amortize Deferred Cost Balance Related to South Carolina Grid

19 The Company proposes to adjust depreciation and amortization expense by
20 \$3,356,000, income taxes by (\$837,000), working capital investment by \$3,356,000, and
21 accumulated deferred taxes by (\$837,000) to amortize the deferred cost balance related to
22 SC grid. ORS proposes to adjust depreciation and amortization expense by \$1,181,000,
23 income taxes by (\$295,000), working capital investment by \$2,475,000, and accumulated

1 deferred taxes by (\$618,000) to amortize the deferred cost balance related to South Carolina
2 grid.

3 Commission Order No. 2018-751 granted the Company's request "to defer the
4 incremental Operating and Maintenance ("OAM"), depreciation and property taxes
5 associated with certain capital assets installed as part of its Power/Forward work, as well as
6 the carrying cost on the investment and on the deferred costs at each utility's weighted
7 average cost of capital." The Commission order also stated "the issuance of the requested
8 accounting order would not prejudice the right of any party to address the prudence of these
9 costs in the Companies' next general rate case proceeding." The Company provided ORS
10 with support for a deferral balance of \$6,713,000 consisting of \$3,277,000 in deferred cost
11 of capital, \$3,171,000 in deferred depreciation, O&M, and property tax expenses, and
12 \$266,000 in after-tax return on deferred costs. The Company proposes amortizing this
13 deferral balance over a two year period, and including the balance less one year of
14 amortization in rate base.

15 ORS proposes a deferral balance of \$5,904,000 which will provide the Company a
16 recovery of the same deferred cost of capital, deferred depreciation, deferred O&M, and
17 deferred property tax expenses as the Company's proposal, but does not include a return on
18 those deferred costs. ORS recommends the deferred cost of capital portion of the deferral
19 balance be included in rate base. ORS does not recommend that the deferred depreciation,
20 O&M, and property tax expense portion of the deferral balance be included in rate base.
21 ORS's recommendation to include the deferred cost of capital portion of the deferral in rate
22 base, and exclude the deferred depreciation, O&M, and property tax expenses from rate base
23 is consistent with regulatory accounting practices for capital-related and operating-related

costs. ORS's recommendation still allows the Company to recover its actual deferred costs through amortization of the proposed deferral balance which is a sufficient level of cost recovery. If the Company is allowed to include depreciation, O&M, and property tax expense in rate base, the Company will earn a return on these expenses.

ORS proposes amortizing the deferral balance over a period of 5 years. This amortization period was provided by the ORS Utility Rates Department, and is addressed in more detail in the testimony of ORS witness Anthony Sandonato.

Q. WILL YOU UPDATE YOUR TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?

A. Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information become available not previously provided by the Company.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.